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E.O. 12958: DECL: 06/26/2016
TAGS: ENRG EPET KZ PGOV PREL
SUBJECT: KAZAKHSTAN: PARKER DRILLING'S LEGAL WOES

Classified By: Pol-Econ Chief Deborah Mennuti; reasons 1.5 (b) and (d).

¶1. (C) Summary: On June 22, Parker Drilling updated Econoff on the company's years-long tax dispute with Kazakhstani authorities. The Supreme Court recently ruled that Parker owed roughly $100 million in back taxes and penalties stemming from work done by Parker's "Sunkar" drilling rig on behalf of operators of the Kashagan offshore field. Parker executives told Econoff that they believe that "KazMunaiGaz insiders" engineered the adverse court ruling in order to facilitate their own purchase of the Sunkar rig. Parker has asked for a supervisory ruling on the Supreme Court ruling, and requests that the USG not/not get involved at this point. End summary.

Supreme Court Assesses $100 Million in Back Taxes and Fines

¶2. (SBU) Econoff met with Houston-based Parker Drilling VP for Operations, Mike Drennon, along with other Parker executives, in Atyrau on June 22, following an adverse Supreme Court ruling in May which ordered Parker to pay approximately $100 million in back taxes and fines.

¶3. (C) Drennon explained that the Court's ruling had actually aggregated two separate tax issues. Parker was not contesting one: a ruling that Parker owed approximately $50 million in value-added tax (VAT), due to Kashagan operator AGIP KCO's incorrect interpretation that its own VAT exemption applied equally to AGIP KCO contractors. Parker was not concerned with this ruling, Drennon said, because AGIP had already agreed to indemnify Parker should Parker lose the case.

¶4. (C) The second $53 million assessment arose from a 2001 Ministry of State Revenue audit of Parker, in which the Ministry claimed that in 1997 Parker miscategorized $99 million received from then-Kashagan operator OKIOC. (As part of its original contract with OKIOC, Drennon explained, Parker had spent $135 million to modernize the Sunkar rig. OKIOC had reimbursed Parker for $99 million, an amount which Parker categorized as a (nontaxable) "capital contribution" rather than "taxable income." The assessed $53 million consists of tax on the $99 million, plus interest and fines.) Parker appealed the 2001 audit results, and in 2002 the Supreme Court ruled in Parker's favor. The case then lay dormant, Drennon said, until 2005, when AGIP revealed that it intended to claim the $99 million expense as "cost oil" once Kashagan production began -- an action that would have reduced the State's tax revenue and profit share. Drennon explained that this announcement provoked the tax authorities to take the case back to court, where, once again, the Supreme Court ruled in Parker's favor in April 2005.

Suspicions of Manipulations of Justice

¶5. (C) The State tax authorities once again appealed the Supreme Court's ruling, Drennon explained, and by May 2006 the case had returned to the Supreme Court, which, for the first time, ruled against Parker. Drennon told Econoff that the company was disturbed by the fact that one of the three ruling justices had been replaced in the middle of the hearings -- a sign, in Drennon's mind, that someone had engineered the unfavorable outcome. The company had subsequently received indications, he said, that "KMG insiders" had manipulated the court decision in order to pressure Parker to accept their earlier offer to buy the Sunkar rig. (Note: Due in large part to the difficulties of shipping rigs to the Caspian, drilling rigs are in high demand in the offshore Caspian. End note.) Drennon said that the Supreme Court's ruling placed the company under substantial pressure, as a $53 million assessment would "wipe out thirteen years of company profits in Kazakhstan." The company had also been told by those presumed to be close to KMG that Parker's tax problems would "go away" if the rig were sold to the prospective buyers.

¶6. (C) Drennon told Econoff that Parker had already won a "stay of execution" of the Supreme Court ruling, and had appealed the decision to a Supervisory Panel of judges. Parker remained optimistic about the possibility of a favorable ruling, he said, and that -- combined with the delicacy of doing battle with KMG insiders -- had led the company to decide not to seek USG assistance at this time. Drennon admitted, however, that even if the Supervisory Panel ruled in Parker's favor, there was nothing to prevent the authorities from advancing the case again whenever "new

circumstances" emerged. A set of "new" circumstances would naturally be created a few years in the future, Drennon acknowledged, whenever Kashagan began production and AGIP began allocating its $99 million Parker payment to "cost oil," thus reducing State tax revenues and KMG's share of Kashagan profits.

¶7. (C) Comment: Despite the length of the court case -- which to date has cost Parker $2.5 million in legal fees -- and the company's current suspicions of judicial manipulation, the Parker executives seemed bullish on Kazakhstan, acknowledging that the company is seeking additional business here. This seeming paradox is, in fact, the key to understanding Kazakhstan's investment climate, where the challenges and risks take a second seat only to the promise of world-class profits. End comment.
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